
CURRENT TRENDS IN GUARANTEEING LOANS – INSTITUTIONAL GUARANTEES –

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Abstract

In this period, an often debated topic is related to credit risk, as more as it manifested lately and caused the trigger of the current crisis. Credit risk is not directly the subject of this work, but especially the ways of hedging credit risk. Therefore I examined in this paper the current trends in guaranteeing loans, respectively the institutional guarantees. Even if, in the other EU countries, loans guarantee funds work from many years in the case of Romania the activity of these funds is at the beginning. Therefore, the experience from other European countries, should lead to some measures that have to be taken in Romania in order to encourage the loans guarantee funds activity and to increase the confidence of the banks in the guarantees provided by this. This action may, on the one hand, facilitate the access of more companies to the credits provided by banks, and on the other hand a way to encourage lending, which can lead to an economic development and can contribute to the overcome of the actual economic crisis.

Keywords: loans guarantee funds, credit risk, SME's, economic crisis.

JEL Classification: E51, E59, H81

Introduction

Protection against credit risk materializes in three key directions⁶⁹:

- risk prevention (cover loan and interest with the economic efficiency of the debtor);
- limiting credit risk by the formation of the specific risk provisions;
- cover loan and interest on the case of the debtor inefficiency.

Credit risk involves the assumption of bank that, at maturity, the customer will not be able to extinguish its obligations to her. For this purpose, the bank, through its specialists, must form an prudent opinion on the real possibility for the beneficiary to repay the loan, and it must take into account not only the first source of repayment for the payment obligation, but also a possible source of secondary recovery of the debt (which concerns mainly the material and financial guarantees of the client).⁷⁰

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⁶⁹ Galiceanu, I., Stanciu, N., Cristea, M., *Gestiune bancară*, Editura Didactica Nova, Craiova, 1997, p. 375

⁷⁰ Rotaru, Constantin, *Managementul performanței bancare*, București, Editura Expert, 2001, p. 612.

Lately, due to the necessity of granting credits for small companies and enterprises, without very substantial assets, or for companies working in agriculture, which guarantees have a lower grade of merchantability, there became well-known institutional guarantees provided by Loans Guarantee Funds (LGF).

On the definition of LGF, some authors consider them to be non banking financial institutions whose role is to take the credit risk of a credit entity by guaranteeing a part of the debt of a client.

Other definitions emphasize the functionality of these funds in order to support SMEs or different branches of the economy, such as institutions that support entrepreneurs with viable projects but which do not have the necessary guarantees for obtaining a credit. International Monetary Fund states that guarantee funds⁷¹ (including the deposits guarantee funds) are institutions that provide their clients against losses arising from financial companies or against financial loss of certain contracts. Under this definition, the guarantee funds:

- i. have no assets in the form of technical reserves of insurance;
- ii. don't have extra-sheet positions;
- iii. don't have to be regulated as insurance companies;
- iv. may be limited to run only certain financial activities.

The given definitions reflect some common features for all the guarantee funds, respectively:

- *Risk sharing between creditors (credit institution) and LGF's*

This share is determined different for each case and guarantee funds can cover up to 100% of the loan requested. However, this case is very rare, because the risk assumed by the funds is maximum in this situation. In most cases, LGF take between 60% - 80% of the risk.

- *Targeting a specific segment of activity*

The main beneficiaries of most guarantee schemes are small and medium enterprises. In many countries, especially the emerging ones, guarantee funds are established and supported by the public institutions or companies operating as non-profit organization, which emphasizes their participation in the process of economic development. Most of guarantee funds select their clients according to certain criteria of industry and / or number of employees, share capital or sales, values which must not exceed certain levels. Another way of filtering is to establish a ceiling on the guarantee, in absolute terms. This ceiling is set at a maximum level which is relatively small, making the large companies not interested in such guarantees.

⁷¹ IMF, *Monetary and Financial Statistics Manual*, 2000

- *Support of viable projects and of projects with impact through the economy*

Projects must be viable because the debtor has to pay back his loan, and has to prove that his project is able to generate liquidity. Therefore, the projects involved must be carefully selected on the basis of economic and financial forecasts. Because the function of guarantee funds is to promote the development of certain economic sectors, this guarantees are given to the impact projects, developed in specific sectors of activity or in specific regions, or to the projects that offer environmental protection, etc..

Small and medium enterprises (SMEs) represent an important sector of any economy. However, SMEs contribute to a large extent to the Gross Domestic Product (GDP) and employs a lot of the labor force. Despite the growth and importance of the SME sector for economic development, they have to face many problems, especially regarding the access to finance through bank loans. According to a study of the European Commission⁷² (EC), between 18% and 35% of SMEs have been refused a loan, in the European Union. Another study showed that EC⁷³, in Romania, the SMEs main source of financing for new projects is represented by their own funds, followed by bank loans and afterwards, by funds granted by the Government or by the European Union.

The main reasons of difficult access to bank loans for SMEs are:

1. from structural point of view, SMEs are more risky than large companies; they are more sensitive to economic shocks, with a lower capacity to absorb the variations than larger companies, which make, especially long-term loans, more risky;
2. in financial terms, SMEs can not sustain a demand for credit with appropriate collaterals, and banks are reluctant to accept personal guarantees;
3. monitoring costs are relatively high compared to the amount of the granted credit;
4. legislation is slow in terms of recovery the debts in the case of bankruptcy.

The existence of guarantee funds resolve some of these problems, respectively offers guarantees when the debtor has not enough and covers a part of monitoring costs, and this kind of intermediation is reducing the price of a loan. In addition, guarantee funds can provide professional evaluation of the projects, provides advice to SMEs on financial management, provides direct credits, etc. However, in considering LGF functions in facilitating the access of less wanted entities for financing, the question is whether this emphasis the pro-cyclical character of the lending. Thus, some authors show that the guarantee funds grow during periods with increase of loans, when the credit institutions would have extended their loan portfolio in a certain proportion to these entities (as a result of high liquidity in the

⁷² *SMEs and Access to Finance*, Observatory of the SMEs in Europe, the Commission, Februarie 2003

⁷³ *SMEs in Europe 2003*, Raport pentru România, Observatory of the SMEs in Europe, the Commission, Iulie 2003

banking system, increased competition between credit institutions), making it difficult to separate the LGFs activity merit of the general business merit.

On how the Loans Guarantee funds operates, there are three main mechanisms for conducting the business of this entities:

➤ first variant, and the most common one, involves the analysis of each application for an institutionalized guarantee, which usually comes from a credit institution partner, when a client has a viable project, that can be finance, but it hasn't enough guarantees;

➤ second type assumes that the request comes directly from the clients, before they contact the credit institution for funding;

➤ finally, other funds work on a portfolio base. Thus, the guarantee funds enable the institution to provide credit guarantees of all businesses that meet certain conditions (the size of the project or associate risk). Because in these automated schemes the evaluation of the projects is made only by the credit institution, the guarantee fund will bear a smaller share of any loss, compared to the share that it would have supported for an application on an individual scheme.

For products and services, guarantee funds can charge fees, both annual, depending on the degree of risk involved in the project and according to the term of the guarantee and for the evaluation of the guarantee demands. These fees, although related to the guarantee risk, they often aim to cover the operational costs of the institution than to reflect the degree of the risk or to generate profit.

To achieve its aim of supporting funding for the entities the guarantees funds must provide confidence to credit institutions with which they have collaboration agreement. Dissemination of detailed pictures of the activities and results, complemented by a rigorous control (both internally and externally by an independent auditor), and a prudential supervision are items which could greatly contribute to the increasing of the confidence and acceptance of the guarantees offered by LGF.

Regulation and supervision of these funds is based on banking law, even if the guarantee funds do not attract deposits and they are using their resources in the activity. The main coordinates in exercising supervision refers to the risk management analysis, with emphasis on solvency. This indicator reports the entity's own funds to risk weighted assets and it is set at least 8% but the minimum level may be more restrictive.

A second large category regarding the regulation and supervision of this guarantee entities consider the LGF in the non-financial institutions group. LGF's are obliged to provide complete and accurate informations to the supervisor about their activity indicators.

Experience of international Loans Guarantee Funds

The structure of Loans Guarantee Funds varies depending on their funding. Can participate together in various forms, the banks, other financial institutions, and recipients of loans.

SC Garantinvest SRL, guarantee company that works in the Republic of Moldova considers the following elements as being essential to the success of Loans Guarantee Funds⁷⁴:

- sufficient initial capital and prudent financial management;
- detailed and rigorous definition of acceptable risk level;
- capacity for assessing risk and a high degree of independence
- segmentation of different types of accepted risks;
- monthly tracking of risks;
- close cooperation and regular communication with the banks;
- level of investment guarantee limited to a maximum of 75%;
- the debtor participation in the financing;
- the existence of a company specialized in the fund management.

Providing and administrating of securities offered by the LGF's can be:

✓ active, in which case the loan proposal is considered by the guarantee fund and this is responsible for the quality of portfolio securities;

✓ passive, case in which the collateral security is granted automatically (based on a simple procedure) and the LGF is not responsible for the quality of securities portfolio.

At the European level there was created the European Association of Mutual Guarantees (AECM - European Association of Mutuel Cautionnement), which is basically an association of guarantee companies or loans guarantee funds from Europe. This association is formed by LGF's from 18 European countries⁷⁵, and from the analysis provided by this association, we found out that each country or regions is distinguished by certain features of guarantee funds.

Thus, in continental Western Europe, there was a real need of mutual guarantee companies, as a practical response to the financing SMEs needs when they did not have sufficient collateral to obtain loans. Mutual guarantee companies is not a direct source of funding, but an instrument through which this funding becomes cheaper and more accessible.

LGF's have emerged as a result of the combination of small entrepreneurs in an attempt to find solutions for the difficult access to the financing from some companies, event that usually appears during an economic crisis. Therefore, in the countries examined, the development of this guarantee funds was often due to an economic crisis or to the need for reconstruction. In most cases, this phenomenon

⁷⁴ Garantinvest – Societate Interbancară de Garantare, “Garanțiile financiare, un instrument eficient de dezvoltare a antreprenoriatului”

⁷⁵ www.aecm.be

has been strengthened by the intervention of governments who were aware of the important role played by the SMEs in national economies.

The origin of mutual guarantee companies coincided with the emergence in France of organizations "Sociétés de Caution mutuelle", created under a law in 1917. Since 1929, similar companies have developed also in Belgium.

Later, during the reconstruction of Europe after the Second World War, a system of guarantee funds developed in Germany and Italy, although here, the developments have been different. Thus, the respective associations in Germany have developed rapidly and have been supported by the state, while in Italy, they have known a real development after the oil crisis triggered in 1973. In Spain, these firms have emerged as an instrument of economic policy and a measure of industrial promotion after 1977, in the beginning of the transition to a democratic society.

Mutual guarantee societies in the Western Europe shows a great disparity. In general, these companies have a mutual character, but there are notable differences from one country to another. They are often formed at national or regional level, but there is also the possibility of a combination of the two situations.

In Germany, there is a system with regional companies, with a multi-regional character, present as a national association. This organization gives to the every guarantee company independence, flexibility in making decision and this determines assuming the risk faster. Have relationships with banks and trading partner of the state, claiming the latter, provided that the business is viable. Since 1991, were assigned tasks and socio-political, such as helping create new jobs.

The guarantee companies have relationships with banks, they are partners of the state, and support the programs provided by the state, as long as this programs are viable. Since 1991, the guarantee companies were assigned also socio-political tasks, such as creating new jobs.

In Belgium there is a shift from a sectoral structure to a regional one. In Spain, there is predominant a regional structure, with a tendency, however, to one company per region. Here it also operate some sectoral organizations. France has developed a model based on the coexistence of two networks of companies: one is multiprofesional and the other is a national network of companies with a sectoral character.

Italy knows a very segmented model. There are over 800 companies with a wide variety of size, business diversification and degree of penetration.

Legal structures for guarantee companies are rather different largely in the EU countries. In Germany, they take the form of limited liability companies, with initial capital subscribed by private organizations such as chambers of commerce and industry, economic federations, professional associations, etc., representing up to 51%, and the remaining 49% it is formed by the capital of banks and savings. In Belgium, the guarantee companies are cooperative societies with limited liability. In Spain, this companies operated as open entities but a law passed in early 1994 turned them into financial institutions.

In France, there are two types of company: most of them, about 80% of the total, were created under the Law in 1917 as cooperative companies and the remaining 20% registered as financial corporations. In Italy, there are also two types of companies: some type of cooperatives, and others that take the form of consortia.

To encourage the business of guarantee companies in certain countries of Western Europe they receive tax incentives, namely:

➤ Germany: loans guaranteeing companies, defined like this by the banking law, are exempt from some taxes and duties;

➤ Spain: guarantee companies pay tax at a lower level compared to other companies. These companies are also exempt from paying other taxes.

➤ France: guarantee companies pay income tax but are exempt from paying taxes for risk provisions created for medium and long term.

➤ Italy: loans guarantee funds are exempt from paying taxes on reinvested profit.

In the countries of Central and Eastern Europe, have grown, in recent years, a number of institutions aiming at supporting SMEs. These institutions were constituted by the State (governments, ministries of finance) as banks of guarantees and development and they are involved in several activities aimed at financial support of the SME's. Guaranteeing loans is, for these institutions, only one of the activities and, in most cases, not the main activity. Risks are assumed by the State, while losses are borne by the budget.

Romanian experience in developing and offering loans guarantee products.

Since the transition from a centralized economy to one based on market principles, Romania was confronted with the situation when small and medium enterprises, in part, have been removed from the country's financial circuit. The entrepreneurs have felt this thing when they wanted to access funds from banks and financial institutions, but did not have enough guarantees.

Given the reduced support for SMEs for developing their business led Romania to take the international experience in order to facilitate SMEs access to financial resources, which was reflected by the creation of 3 specialized financial institutions in granting loans guarantees:

1. Romanian Fund for Credit Guarantee (FRGC);
2. Guarantee Fund for Rural Credit (FGCR);
3. The National Credit Guarantee for Small and Medium Sized Enterprises

In Romania, the Loans Guarantee Funds have the legal form of stock company, which awarded them maximum flexibility in making decisions. The main founders of these organizations are credit institutions and financial companies in the proportion of 92% for FGCR and 84% for FRGC. The shareholder of FNGCIMM is only the Romanian state, represented by the National Agency for Small and Medium Enterprises.

The target for the granting of guarantees are:

➤ FGCR is the only fund in three specialized on a sector of the economy. Letters of guarantes can be obtained by individuals and legal entities, including start-ups companies, which are producers and processors of agricultural products, for loans provided for agricultural production and achieving investment in agriculture;

➤ FNGCIMM guarantes loans and other financial instruments that can be obtained by SMEs from financial institutions which meet the eligibility criteria established by the Fund (viable business plan, lack of outstanding loans, classification in standard, in observation and substandard category, according to the classification of National Bank of Romania, etc.);

➤ FRGC guarantes the vast majority of private entrepreneurs, including newly-formed, only if they have commercial and financial credibility.

Starting from the particularities of local market, the Loans Guarantee Funds have chosen the mechanism of active operation of the guarantee, which involves risk analysis for each client separately. Potential beneficiary of the guarantee requires financing from a bank and after the approval of the loan goes to the guarantee fund. Providing gurantees by the Fund is based on an analysis of its own, done after a "scoring" system, composed of economic and financial (quantitative) and some qualitative factors (eg.: SME's management, industry, competition, quality of debtors and creditors, etc).

Often, the requirements of the guarantee funds for SMEs are more severe than those of the banks, which can be explained by different degree of the effect of default on the bank and on the fund.

Loans Guarantee Funds, as well as credit institutions, use prudentiality indicators in order to cover against credit risk. These indicators are related to:

➤ maximum exposure to a single borrower, which in the case of the 3 credit guarantee funds is 20%, representing the ratio between the amount of exposure to a borrower and the level of its own funds;

➤ maximum exposure to a credit institution - all 3 funds establish the level for this limit annual, and in the case of FNGCIMM, maximum exposure to the credit institution may not exceed 40% of total granted guarantees;

➤ maximum weighted security against the loan amount, which differs from a guarantee fund to another, as follows:

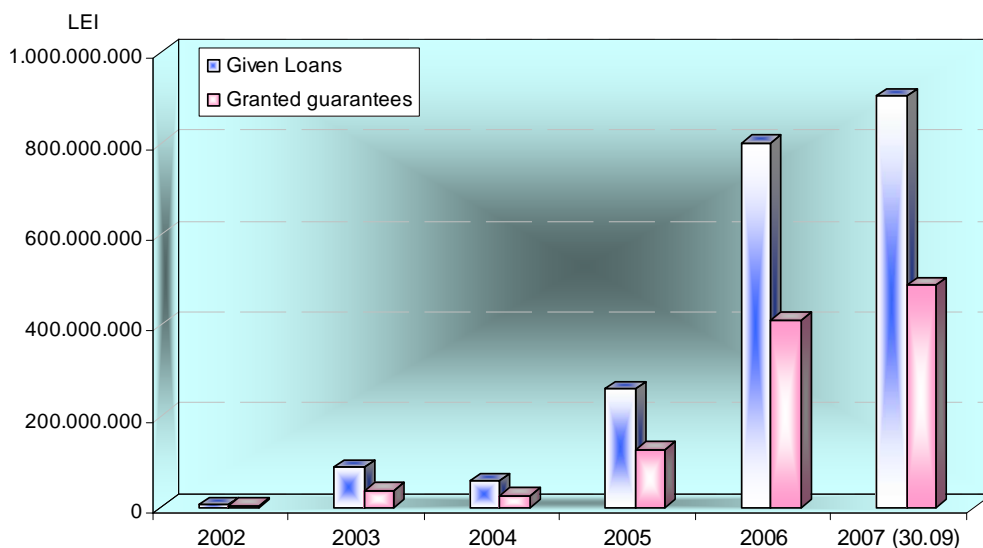
- FRGC - up to 70%;

- FGCR - maximum 50% of the loans for short term and 70% of the loans to medium and long term, subject to a ceiling of 250,000 to 1,000,000 euros, depending on the type of customer, and can reach up to 100% of the exposure when lending to co-finance European funds;

- FNGCIMM - between 60% and 80% depending on the duration of the guarantee, seniority in the business of the recipient, and other indicators of internal analysis.

Regarding the number and value of guarantees, the information is offered only by FNGCIMM. This reflects an increase of the warranty offered since 2006. The performances of the FNGCIMM are as follows (graphic 1 and 2):

Given loans / granted guarantees (2002 - 30.09.2007)



Sursa: FNGCIMM – The advantages of using FNGCIMM products for implementing the projects financed by the european funds, december 2007

This increase is determined mostly by the booms that took place on the loans market since 2006 as a result of the increasing appetite of the companies for investments, even if you do not have money or guarantees of their own.

In addition, even if some funds are functional from a large period of time (FGCR from 1994, FNGCIMM from 2001) their activity became known only in last years. This is due first to a lack of information to the customers and secondly to a lack of interest in promoting such guarantees from banks. This is caused by a lack of trust from banks in the guarantee funds activity due to the fact that until 2 years, guarantees provided by this funds could not be deducted from the loans, which cause an increase in provisions in case of such loans became outstanding. Not even now, banks don't have complete confidence in the institutionalized guarantees, which is why the guarantees could only be 50% deducted from the loan value when calculating the provisions.

Conclusion

I consider that this perception of the banks should change, because institutional guarantees represents a good option for economic development by facilitating the financing of the small and medium enterprises. This is even more important considering the general crisis that the economy is going through. Economic crisis has

been caused by excessive growth of lending and that's why, now, the banks have an excessive prudentiality in terms of granting loans. At the same time, many specialists believe that overcoming this crisis can only be achieved if bank restart their loan activity in order to stimulate the companies investments. This is not possible without the support from the loans guarantee funds, because at this time other warranties (securities and real estate) no longer determine an appropriate risk coverage due to the reduction of their liquidity on markets affected by the economic crisis.

Thus, in several words country, as well as in Romania, one way of hedging credit risk are the guarantees. Experience in international lending has stressed the fact that in some areas, very important in developing countries economy, the guarantees offered by the beneficiaries of this credit are of lower quality, and so, they can not determine the reduction of the associate risks. Therefore, a solution found to solve this problem and facilitate access to credit was the creation of guarantee funds, as institutions that assume the risk of default of loans. In Romania these types of securities, although they exist from several years, they were not very good fructificate, as a result of the bank perception about them. Currently, securities issued by the Guarantee Fund start to increase, especially because the companies understood the fact that they facilitate the acces to bank loans and european funds. Still, I consider that this guarantees should be better promoted and supported by state and national bank in order to increase the contribution of this loans guarantees funds to overcome the economic crisis, and for this they should take the example of the facilities provided to these funds in other european countries.

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